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# USE OF DERIVATIVES BY CONNECTICUT MUNICIPALITIES

By: Rute Pinho, Associate Analyst

You asked whether state law allows municipalities to invest in derivatives and, if so, how many of them have done so.

## SUMMARY

Derivatives are financial instruments that derive their value from one or more underlying assets, such as stocks, bonds, or market indices. They include interest rate swaps, futures or options contracts, and other similar instruments. Investors can use them to (1) "hedge" or mitigate the risk of economic loss arising from changes in the value of an underlying asset or (2) "speculate" or increase their profit should the value of the underlying asset move in the direction they anticipate.

State law explicitly allows municipalities to use derivative products when issuing bonds or incurring other types of debt and establishes certain requirements they must meet when doing so. However, the law does not specify whether they may invest public funds or retirement plan assets in derivatives.

State municipal finance laws do not include derivatives in the list of permissible investment instruments, which include certain federal, state, and local obligations and money market mutual funds, custodial arrangements, and pools (CGS § 7-400). Moreover, the law does not prescribe the types of investment instruments in which municipalities may invest retirement plan assets. Instead, it requires that towns invest

and manage such funds in accordance with the plans' terms and comply with the statutory standards for the prudent investor (CGS §§ 7-450(b) and 45a-541 et seq). Thus, any derivative products in a municipality's retirement asset investment portfolio would have to comply with the retirement plan's investment terms and prudent investor standards. It is unclear whether these could preclude investments in derivatives and other similar financial instruments.

Neither the Office of Policy and Management, Connecticut Conference of Municipalities, nor Government Finance Officers Association (GFOA) of Connecticut have compiled data on municipal use of derivatives. We are still trying to collect this information and will provide it in a follow-up report.

For your further review, we attach copies of two GFOA advisory statements related to state and local government use of derivatives. The first is specific to the use of derivatives in non-pension fund investment portfolios. The second is related to the use of debt-related derivatives. Both advise state and local government finance officers to exercise caution in the use of derivatives and not use them for speculation.

## DERIVATIVES

Derivatives are financial instruments created from or whose value depends upon the value of one or more underlying assets or indices of asset values. They may include interest rate swaps, futures or options contracts, and other similar instruments. An interest rate swap is a contract in which two parties agree to exchange interest payments of differing character, such as a fixed for a variable interest rate, based on an underlying principal amount that is not exchanged. Futures and options contracts allow an investor to buy or sell a particular financial instrument or security at a predetermined price in the future.

Investors can use derivatives to "hedge" or mitigate the risk of economic loss arising from changes in the value of the underlying asset. For example, a government could use an interest rate swap to trade a variable rate bond issuance for a fixed rate of interest, allowing it to hedge against interest rates rising and thus save some money. But whether the government realizes any savings depends on whether variable rates rise or fall relative to the fixed rate.

Investors can also use derivatives to “speculate” or increase their profit should the value of the underlying item move in the direction they anticipate. For example, investors may enter into a derivative contract to buy an asset in the future at a low price when the future market price is high or sell an asset in the future at a high price when the future market price is low.

## MUNICIPAL BOND ISSUANCES

State law allows municipalities to use "interest rate swap agreements" in connection with issuing or carrying bonds or notes. These agreements can include futures contracts, options, puts (contracts to sell at a predetermined price), calls (contracts to buy at a predetermined price), and other similar risk management mechanisms.

The law also establishes certain requirements municipalities must meet when entering into these agreements. It:

1. requires the agreements to contain whatever payment, security, default, remedy, or other terms and conditions the municipality thinks appropriate;

2. allows municipalities to select the other party in such an agreement through negotiation or competitive bidding;

3. requires municipalities in selecting the other parties, to consider (a) the party's ability to meet its obligations, including its ratings by nationally recognized rating agencies, (b) the impact of the agreement on the ratings of any outstanding municipal bonds or notes, and (c) any other criteria they consider appropriate; and

4. requires the other party's unsecured long-term debt to be rated in the (a) AA category or above by at least one nationally recognized rating agency or (b) lower A category if they can provide collateral to enhance their credit and are a qualified public depository (CGS § 7-370b).

## MUNICIPAL INVESTMENT

### *Municipal Funds*

State municipal finance laws specify the types of financial instruments in which town treasurers may invest public funds. Specifically, CGS § 7-400 allows town treasurers, with the approval of the town's budget-making authority, to invest the proceeds received from the sale of bonds, notes, or other obligations, or other funds in the obligations of:

1. any state, or any political subdivision, authority, or agency thereof, if they are rated within one of the top two rating categories of any nationally recognized rating service or one that the banking commissioner recognizes;

2. the state of Connecticut, or any regional school district, town, city, borough, or metropolitan district in the state if the obligations are rated within one of the top three rating categories of any nationally recognized rating service or one that the banking commissioner recognizes; and

3. the United States, including those of the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, the Government National Mortgage Association, or any other federal agency.

In addition, towns may invest in certain money market mutual funds, custodial arrangements, and pools. The portfolios of these investment vehicles (1) are limited to the same U.S. government obligations described above; (2) must meet other conditions regarding the delivery of collateral, management, and credit rating of the investment company or investment trust, and (3) can be made only through a state or federal bank, savings bank, or an out-of-state bank with a branch in the state (CGS § 7-400).

### *Pension Funds*

State law gives municipalities broad authority to invest and manage retirement plan assets. It requires municipalities to hold and invest these assets in accordance with the plan's terms and comply with the statutory standards for the prudent investor (CGS §§ 7-450(b) and 45a-541 et seq). Subsequently, any derivative products in a municipality's pension fund investment portfolio must comply with the pension plan's investment terms and prudent investor standards.

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